

Message Text

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ACTION EB-07

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TO SECSTATE WASHDC PRIORITY 1739

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AMEMBASSY ALGIERS

AMEMBASSY BEIRUT

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E. O. 11652: N/A

TAGS: ENRG, NI, OPEC

SUBJ: NIGERIA'S NEW OIL PRICES

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REF : ALGIERS 3081

SUMMARY: THIS MESSAGE TRANSMITS NIGERIA'S NEW OIL PRICES, ATTEMPTS TO ANALYZE THE FACTORS THE FMG CONSIDERED IN SETTING THEM AND COMMENTS ON THEIR POSSIBLE EFFECTS ON PRODUCTION AND OIL COMPANY INVESTMENT. ON OCTOBER 13, FMG RAISED PRICE OF DIRECT SALE CRUDE TO DOLLARS 12.51, INCREASED AND EXTENDED COVERAGE OF HIGH GRAVITY PREMIUM, AND TIGHTENED CREDIT TERMS. SHARP PICKUP IN SPOT PRICES AND LIFTINGS IN SEPTEMBER, POSSIBILITY OF INCREASING DEMAND IN EUROPE FOR AFRICAN CRUDES WITH LOW RESIDUAL FUEL OIL YIELD, AND GRADUAL RECOVERY OF U.S. ECONOMY MAY HAVE ENCOURAGED NIGERIANS TO RAISE PROCES HIGHER THAN SOME HAD PREVIOUSLY EXPECTED THEY WOULD. NIGERIANS MAY ALSO HAVE SET PRICE IN CLOSE COORDINATION WITH ALGERIA. INDUSTRY SOURCES SAY NIGERIAN PRICES ARE TOO HIGH AND FORESEE ANOTHER SHARP CUTBACK IN DEMAND AND PRODUCTION. PROSPECT OF REDUCED TOTAL REVENUES, PLUS SMALL EROSION OF MARGINS UNDER NEW PRICE STRUCTURE, HAS DONE NOTHING TO ENCOURAGE OIL COMPANIES TO REVERSE DECLINE IN THEIR PLANNED CAPITAL INVESTMENT OUTLAYS. NIGERIA, ON THE OTHER HAND, WILL NEED SUCH INVESTMENT TO ASSURE STEADY FUTURE PRODUCTION. END SUMMARY.

1. F.R.A. MARINHO, NEW ACTING DIRECTOR OF PETROLEUM RESOURCES, MINISTRY OF PETROLEUM AND ENERGY (MPE), SENT LETTER TO COMPANIES OCTOBER 13, WITHOUT USUAL PRIOR ORAL CONSULTATIONS, SETTING NEW CRUDE PRICES EFFECTIVE OCTOBER 1. BUYBACK PRICE OF 34 GRAVITY MARKER CRUDE INCREASED FROM DOLS 11.35 TO 12.51, AND POSTED PRICE SET AT DOLS 13.07, COMPARED TO THIRD QUARTER LEVEL OF 11.66. PREMIUM FOR HIGHER GRAVITIES, FORMERLY 3 CENTS PER DEGREE UP TO 36 GRAVITY ON THE POSTED PRICE AND ONE AND ONE-HALF CENTS PER DEGREE ON BUYBACK PRICE, WILL NOW BE 3 CENTS PER DEGREE ON BOTH POSTED AND BUYBACK PRICES UP TO 40 DEGREES. CREDIT TERMS REDUCED FROM 90 TO 60 DAYS, WITH PROVISIO THAT AN EXTRA 30 DAYS CAN BE PURCHASED AT COST OF 10 CENTS PER BARREL.

2. COMPANIES CONSIDER THIS CREDIT CHARGE IMPORTAN, SINCE IT MEANS IN EFFECT THAT NEW PRICE IS ACTUALLY EQUIVALENT TO DOLLARS 12.61, WHICH IS DOLLARS 1.26, OR 11.1 PERCENT, HIGHER LIMITED OFFICIAL USE

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THAN THIRD QUARTER BUYBACK PRICE. LOOKING AT NEW PRICE FROM ANOTHER ANGLE, DIFFERENTIAL BETWEEN SAUDI ARABIAN MARKER CRUDE AND NIGERIAN BUYBACK PRICES WAS 89 CENTS IN THIRD QUARTER, OR 8.5 PERCENT. NOW IT IS DOLLARS 1.10, OR 9.6 PERCENT.

3. MARINHO TOLD ECON COUNSELOR AND PETROLOFF OCTOBER 22 THAT NIGERIAN PRICE WAS SET BY SIMPLY INCREASING SAUDI ARABIAN

MARKER CRUDE THE AGREED-UPON 10 PERCENT, FROM 10.46 TO 11.51, AND ADDING ONE DOLLAR PREMIUM. (SOURCES TELL US MARINHO AND MPE PERMSEC AWONIYI THEN ADJUSTED POSTED PRICES SO AS TO KEEP THEORETICAL COMPANY MARGIN AT 40 CENTS.) MARINHO SPECIFICALLY COMPARED NIGERIAN ACTION WITH ALGERIAN INCREASE OF ONE DOLLAR TO 12.75 AND, LIKE ALGERIANS (SEE REFTEL, STRESSED THAT 10 PERCENT OPEC INCREASE APPLIED ONLY TO SAUDI ARABIAN MARKER CRUDE. WE HAVE HEARD THAT NIGERIANS AND ALGERIANS WORKED CLOSELY TOGETHER IN SETTING NEW PRICES IN ORDER TO ESTABLISH COMPETITIVE EQUILIBRIUM. IT WOULD INDEED APPEAR THAT NIGERIANS HAVE AS ALGERIAN PRESS SERVICE PREDICTED IN REFTEL, CO-OPERATED IN RAISING THEIR PRICE CONSIDERABLY MORE THAN DOLLARS 1.05. IT ALSO LOOKS LIKE THE NIGERIANS, POSSIBLY IN A DEAL WITH THE ALGERIAN, COSMETICALLY DISGUISED PART OF THE INCREASE IN THE CHANGE CREDIT TERMS. THIS ENABLES THEM TO CLAIM, AS MARINHO TOLD US, THAT THEY RAISED THEIR DIFFERENTIAL BY ONLY ONE DOLLAR, NO MORE AND NO LESS THAN THE ALGERIANS. WE HAVE ALSO HEARD THAT ALGERIANS AND NIGERIANS TRIED UNSUCCESSFULLY TO GET LIBYANS TO GO ALONG.

4. WHY DID NIGERIANS SET THEIR PRICE SO HIGH WHEN, EARLY IN THIRD QUARTER, NIGERIAN CRUDE AND 11.35 WAS SAID TO BE OVERPRICED AND OUT OF LINE WITH SIMILAR LIBYAN CRUDES AT 11.10? SOME SOURCES EXPECTED THAT IF OPEC RAISED PRICE BY ONE DOLLAR, NIGERIA WOULD LOWER ITS SULFUR DIFFERENTIAL IN ORDER TO HOLD ITS TOTAL PRICE INCREASE TO ABOUT 70 CENTS. WHILE THIRD WORLD POLITICAL SOLIDARITY IS FINE, WE DOUBT THE NIGERIANS WOULD HAVE RAISED THEIR PRICES AS HIGH AS THEY DID IF THEY DIDN'T THINK THEY COULD GET AWAY WITH IT ECONOMICALLY. IN SEPTEMBER, ACCORDING TO PETROLEUM INTELLIGENCE WEEKLY (PIW), STRONG HEDGE BUYING IN ANTICIPATION OF THE OPEC DECISION LIMITED OFFICIAL USE

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WAS FOCUSED ON AFRICAN LIGHT CRUDES, MAINLY BECAUSE WEST GERMAN REFINERIES, FACING WINTER PEAK SEASON DEMAND FOR GAS OIL, BUT ALREADY SADDLED WITH EXCESS STOCKS OF HEAVY RESIDUAL FUEL OIL, WERE SWITCHING TO CRUDES WITH THE LOWEST POSSIBLE RESIDUAL FUEL OIL YIELDS. THIS DEMAND SHIFT COINCIDED WITH LIBYAN PRODUCTION CUTBACKS AND PRE-OCTOBER HEDGE BUYING TO DRIVE SPOT QUOTATIONS FOR BOTH LIBYAN AND NIGERIAN CRUDES WELL ABOVE THE NIGERIAN BUYBACK PRICE, TEMPORARILY ELIMINATING THE PROBLEM OF OVERPRICING FOR THE NIGERIANS. IN ADDITION TO THESE CHANGES IN PRICES AND EUROPEAN DEMAND, THE NIGERIANS MAY HAVE CONSIDERED THAT DEMAND IN THEIR MAJOR MARKET, THE U.S., WOULD PROBABLY STRENGTHEN AS THE U.S. ECONOMY EMERGED FROM RECESSION.

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THEIR OWN PRODUCTION FIGURES WOULD HAVE APPEARED TO SUPPORT

SUCH AN IDEA: FROM 1.64 MILLION BARRELS PER DAY IN JULY,

PRODUCTION ROSE TO 1.76 MILLION IN AUGUST AND AN ESTIMATED

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1.92 MILLION IN SEPTEMBER. MARINHO ALSO TOLD US THE NNOC HAD BETTER SUCCESS IN SEPTEMBER IN LOCATING BUYERS FOR ITS DIRECT SALE OIL, NEGOTIATING CONTRACTS FOR PERHAPS ANOTHER 100,000 BARRELS PER DAY TO BRING THE TOTAL UP AROUND 280,000 BARRELS PER DAY. (SHELL U.S., CITIES SERVICE, AND CROWN CENTRAL CONTINUE TO BE THE BIGGEST BUYERS OF DIRECT SALE OIL.) TAKING ALL THESE FACTORS INTO ACCOUNT, THE NIGERIANS MAY WELL HAVE CALCULATED THAT THE WORLD MARKET FOR AFRICAN LIGHT CRUDES WOULD BE STRONG ENOUGH TO SUPPORT THE PREMIUM AND CREDIT INCREASES THEY APPLIED ON TOP OF THE 10 PERCENT OPEC MARKER INCREASE.

5. IS NIGERIAN OIL NOW OVERPRICED? ACCORDING TO PIW, LIBYANS, WHOSE PRICES WERE UNDERCUTTING NIGERIA'S IN SECOND QUARTER, WILL BE RAISING PRICES BY A FLAT 10 PERCENT. THIS MEANS, FOR EXAMPLE, THAT 37 GRAVITY ES SIDER WILL NOW BE PRICED AT 12.21. COMPARABLE 37 GRAVITY NIGERIAN CRUDE, COSTING 12.54, HAS A 9 PERCENTAGE POINT LOWER HEAVY RESIDUAL FUEL OIL YIELD, AND CORRESPONDINGLY HIGHER MIDDLE DISTILLATE AND NAPHTHA YIELDS. THIS WOULD MAKE NIGERIAN CRUDE VERY ATTRACTIVE IN EUROPE NOW, AND JUSTIFY A PREMIUM, BUT PROBABLY NOT AS MUCH AS 33 CENTS A BARREL. A DOWNWARD ADJUSTMENT WOULD ALSO HAVE TO BE MADE FOR NIGERIA'S GREATER DISTANCE FROM THE EUROPEAN MARKET, EVEN AT PRESENT DEPRESSED FREIGHT RATES.

6. THE LATEST NEWS WE HAVE ON PRODUCTION AND LIFTINGS DOES INDICATE THAT NIGERIA'S PRICE IS TOO HIGH. SHELL REPORTEDLY SHUT IN A 200,000 BARREL PER DAY FIELD ON OCTOBER 21. THE NNOC HAD PREVIOUSLY INFORMED ANOTHER OIL COMPANY THAT IT WOULD NOMINATE SHIPS TO LIFT ITS ENTIRE QUOTA OF OCTOBER PRODUCTION, BUT THE OIL COMPANY NOW FINDS NO SHIPS CALLING AND NNOC LIFTINGS RUNNING 40,000 BARRELS PER DAY BEHIND. IT APPEARS POSSIBLE THAT BUYERS WHO CONTRACTED WITH THE NNOC FOR OCTOBER CRUDE AT SEPTEMBER PRICES, PLUS WHATEVER THE OPEC INCREASES WOULD BE, ARE NOW FREE TO CANCEL THEIR CONTRACTS SINCE NIGERIA'S PRICE INCREASE WAS GREATER, AND ARE DOING SO. HOW BADLY THE NIGERIANS HAVE WOUND UP OVERPRICING THEIR OIL ALSO DEPENDS ON SEVERAL UNKNOWNNS, SUCH AS WHETHER LIBYA WILL MAINTAIN ITS PRODUCTION CUTS, WHETHER EUROPE HAS A MILD WINTER, AND WHETHER PRESENT U.S. DEMAND FOR LOW SULFUR CRUDE IS AS PRICE ELASTIC AS IT WAS IN

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EARLY 1975. A MAJOR TEST OF NIGERIA'S PRICING COULD OCCUR IN THE FIRST QUARTER OF NEXT YEAR, SINCE BUYBACK COMMITMENTS IN THE PRESENT PARTICIPATION AGREEMENT ARE SUPPOSED

TO TERMINATE AT THE END OF 1975. THE NNOC WOULD THEN TECHNICALLY BE RESPONSIBLE FOR FINDING BUYERS, NOT JUST FOR 30 PERCENT, BUT FOR ITS ENTIRE 55 PERCENT SHARE OF TOTAL PRODUCTION. SINCE NIGERIA SETS ITS PRICES EACH QUARTER, IT COULD IF IT WISHED REDUCE ITS PRICE AT THE END OF THE YEAR TO OVERCOME THE PROBLEM OF WHAT TO DO WITH ALL THAT OIL.

7. WHAT ABOUT THE EFFECT OF THE NEW PRICE ON THE OIL COMPANIES? THE SECOND AND THIRD QUARTER PRICE CUTS IMPROVED COMPANY MARGINS ANYWHERE FROM FOUR TO SIX CENTS A BARREL ON ALL OIL PRODUCED, AND BY AS MUCH AS FOURTEEN CENTS A BARREL ON EQUITY OIL. THE NEW PRICE STRUCTURE HAS LOWERED MARGINS BY ABOUT 4 CENTS ON ALL OIL PRODUCED, AND 8 CENTS ON EQUITY OIL. SEVERE OVERPRICING AND LOWER MARGINS COULD BRING TO A HEAD A DEBATE BETWEEN THE COMPANIES AND THE GOVERNMENT OVER WHETHER THE COMPANIES ARE ENTITLED TO CONSIDER AS THEIR EQUITY OIL AN ABSOLUTE QUANTITY EQUAL TO 45 PERCENT OF TOTAL ALLOWABLE PRODUCTION CEILINGS, WHETHER OR NOT ENOUGH OIL CAN BE SOLD TO KEEP PRODUCTION UP TO THOSE CEILINGS AT EXISTING GOVERNMENT DICTATED PRICES, OR WHETHER 55 PERCENT OF EACH BARREL, REGARDLESS OF HOW LOW HIGH PRICES DEPRESS TOTAL PRODUCTION, BELONGS TO THE NNOC AND 45 PERCENT TO THE COMPANIES. THE MORE DIFFICULT IT MIGHT BECOME FOR THE NNOC TO FIND BUYERS AT DIRECT SALE PRICES, THE HARDER IT COULD BE EXPECTED TO INSIST ON THE LATTER POSITION, KNOWN LOCALLY AS THE "INDIVISIBLE MOLECULE THEORY". SINCE THE PARTICIPATION AGREEMENT HAS NEVER BEEN FORMALLY SIGNED BY FMG, THE COMPANIES WOULD FIND IT DIFFICULT TO SUPPORT THEIR POSITION BY INSISTING ON THE AGREEMENT'S TERMS.

8. IFOVERPRICING OF NIGERIAN OIL FORCES SUBSTANTIAL PRODUCTION CUTBACKS, AND THE NIGERIAN GOVERNMENT INSISTS ON THE INDIVISIBLE MOLECULE THEORY OF PARTICIPATION, THE RESULTING COMBINATION OF LOWER MARGINS ON REDUCED SALES VOLUME WOULD SHRINK THE CASH FLOW OF THE OIL COMPANIES TO THE POINT WHERE IT WOULD NO LONGER SUPPORT THEIR EXISTING CAPITAL INVESTMENT PROGRAMS. WITH MARGINS CONSIDERED TOO THIN, EXCESS CAPACITY ALREADY IN PLACE, AND GOVERNMENT LIMITED OFFICIAL USE

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INTERPRETATIONS OF PARTICIPATION UPSETTING THEIR REVENUE FLOW PROJECTIONS, THE COMPANIES HAVE VIRTUALLY NO INCENTIVE TO MAKE ANY MAJOR NEW INVESTMENTS IN DEVELOPING OIL PRODUCTION IN NIGERIA. ONE COMPANY TOLD US IT HAS ALREADY REDUCED ITS INVESTMENT PROGRAM FOR 1975 FROM 160 MILLION DOLLARS TO 40 MILLION. A NEW DEPRECIATION LAW, WHICH WOULD HAVE ENABLED OIL COMPANIES TO WRITE OFF MOST OF AN INVESTMENT IN FIVE YEARS, WAS PROPOSED LAST JULY. ACCORDING TO OIL COMPANY SOURCES, THIS WOULD DO A LOT TO ENCOURAGE NEW INVESTMENT EVEN AT PRESENT LOW MARGINS, BUT NO CONCRETE

ACTION HAS YET BEEN TAKEN ON THE PROPOSAL. SINCE NIGERIA'S FOREIGN EXCHANGE RESERVES WILL DECLINE SHARPLY OVER THE NEXT FEW YEARS, ACCORDING TO MOST ESTIMATES, THE FMG MUST STILL ATTRACT SUBSTANTIAL FOREIGN INVESTMENT TO DEVELOP THE NEW CRUDE SOURCES IT NEEDS JUST TO KEEP PRODUCTION-- AND REVENUES--STEADY EVEN AT REDUCED CONSERVATION LEVELS. THE LATEST PRICE INCREASE HAS DONE NOTHING TO PROMOTE SUCH A STRATEGY.
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